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## DIRECTORATE OF INTELLIGENCE

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China: New Attention to Selected Economic Reforms

Summary

Although fullscale industrial management reforms have been delayed until after 1985, Beijing is pushing forward selected trial reforms in several critical areas. Recent official Chinese statements have announced new initiatives in reforming industrial administration, commerce, and the tax and wage systems, while continuing previous reforms in industry and agriculture. Larger economic and political considerations such as Party rectification and government reorganization, however, preclude widespread movement on most economic reforms until after 1985. The current attention to reform, nevertheless, stands in distinct contrast to 1982, when the reform movement was in the doldrums, and signals that pro-reform elements in the government feel strong enough to press their case again.

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Delay Acknowledged

In his December report on the 6th Five-Year Plan to the National People's Congress (NPC), Premier Zhao Ziyang addressed the topic of economic management reforms in industry and commerce, which were slowed in 1981 because of unanticipated side-effects and political opposition. He argued that the government still intends to carry out reforms, but that conditions will not be ripe for full-scale reforms--including all-important price reforms--until the Sixth Five-Year Plan is completed in 1985.

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In the meantime, Premier Zhao said that China will experiment with certain specific reforms and that this will pave the way for putting together a blueprint for a comprehensive reform program after 1985. In our view, this estimate is very optimistic, and we believe that the road to fullscale economic reforms will be rocky and take longer to traverse than the current ambitious plan allows. In any case, the Chinese press has played up these experiments recently and has disclosed some details of the intended direction of reforms. [redacted]

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#### Reforms In Profits and Taxes...

The government intends to replace the current system of profit remittances, which discourage economic efficiency, by installing a progressive enterprise tax system. Heretofore, enterprises were not held accountable for profits or losses; under the new system, they will be forced to pay taxes to the government and will not be automatically protected against losses resulting from bad management. Experiments in which state-owned enterprises substituted taxes for profit payments to the government first emerged in 1980, but the number of enterprises taking part in the experiment has remained small. According to recent press reports, this method will be applied more widely in 1983. Beijing municipality, for example, is doubling the small number of enterprises converting to tax payments. [redacted]

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At the moment, most enterprises involved in the experiment remit not only taxes on income and on fixed and working capital, but also an "adjustment tax," to compensate for any especially favorable conditions--such as prices--which earn the plant excessive profits. In our view, nationwide conversion to such a system will have to wait until comprehensive price reform takes place after 1985, if a working tax system is to play a stimulative role in the economy. [redacted]

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#### ...In Administration...

To reduce unnecessary layers of overlapping administration, the government has proposed gradually placing most enterprises under municipal authorities and phasing out provincial or prefectural oversight. The proposed reform will continue central control over a few major enterprises. In a parallel government reform, prefectures will be abolished. Liaoning province, which has taken the lead in pioneering this reform, has already abolished most of its prefectures. We believe this reform will require some revision of fiscal practices, as provincial authorities are divested of enterprises and are left without a traditional source of income. [redacted]

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#### ...In Commerce...

The third area where reformers plan to push forward is in the cumbersome system of marketing industrial and agricultural goods. The commercial system is, for all practical purposes,

state-owned, and commodities pass through numerous hands as they move from factory to consumer. This system served an important allocating function in periods during which goods were relatively scarce or rationed. In the past few years, however, availability of consumer goods has expanded and the state-managed system is unable either effectively to move goods to consumers or to convey the intricacies of consumer demand to producers. The Chinese media indicate a major source of government and consumer dissatisfaction with the commercial system has been its increasing inability to meet the demands of China's large rural population, whose cash income has grown rapidly in recent years. [redacted]

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A recent National Commercial Work Conference came down forcefully on the side of reform, and Chinese media coverage of it noted that not only should the state-owned commercial sector be held responsible for its lackluster performance but also collective and private commercial enterprises should be permitted to grow rapidly to fill gaps in the state-owned sector, particularly in rural areas. The conference blamed the lack of effective commercial reforms in the past few years on "leftist" thinking, a euphemism for entrenched interests. The Chinese press indicates that this reform will be phased in gradually. [redacted]

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#### ...And In Wages

Beijing is also beginning to experiment in state-owned enterprises with a more flexible wage system that ties worker pay to productivity. China's wage system has remained unchanged since 1956, with workers paid a fixed salary regardless of their performance. Since 1978, most state-owned enterprises have instituted bonus schemes, but these failed to spur worker productivity because they have almost always been distributed equally among the workforce. [redacted]

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China's trade union newspaper recently urged state-owned enterprises to adopt the "floating" wage system currently practiced in some collective enterprises. According to the paper, a comparison of performance in two construction enterprises--one state-owned and the other collective--showed productivity to be far greater in the collective enterprise. The paper attributed this to the fact that only a portion of a collective worker's income is fixed; the remainder is based upon his performance. Beijing municipality, according to another press report, has decided to experiment with a similar floating wage system in 10 state-owned enterprises. We believe this reform is also intended to reduce industrial labor costs and lighten the government's subsidy burden. Like the changes in the commercial system, the reform in the wage system will occur gradually, presumably because many workers will object to a reform which will reduce their currently guaranteed income. [redacted]

Perfecting Ongoing Reforms

Beijing has also stated that economic reforms that have already been widely implemented, such as responsibility systems in agriculture and industry, have been only partially effective and must be improved. This is particularly true in the case of economic responsibility systems (ERS) in industry, the centerpiece of industrial reforms in 1981 and 1982. ERS were intended to define the relationship between government, enterprise, and worker; the prerogatives and responsibilities of each, however, have been unclear since reforms began. In fact, the enterprises and workers have been quick to take advantage of prerogatives--e.g., retaining earnings and paying bonuses. The government believes these two levels have shirked their responsibilities under the system--e.g., misspending retained earnings and not reducing production costs. The government, in recent media editorials, argues that it is now time to perfect the ERS and restore some balance to the program by enforcing the responsibilities. [redacted]

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Agricultural production responsibility systems (PRS) have developed rapidly over the past four years.\* PRS link performance with remuneration by setting out production quotas in written contracts and turning most production decisions over to individual peasants who are free to dispose of over-quota production. We attribute much of the excellent performance in agriculture in the past few years to this policy and to a government decision to raise agricultural procurement prices. The government recently made another long-awaited move in agricultural reform by approving experiments destined to alter radically or abolish completely China's rural communes. We believe this will have only a small economic impact, but it is an important political symbol of Beijing's willingness to reject counterproductive Maoist institutions. In some localities, according to press reports, the communes have already been supplanted by townships, the local government level which the communes replaced in 1958. [redacted]

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However, First Things First

All this movement on reform experiments does not mean that 1983 will see far-reaching economic reforms, and there continue to be serious obstacles to implementing a complete economic reform package immediately. The obstacles include economic factors, such as the irrational price system and current investment requirements, and political factors, such as opposition from ideological or parochial interests. [redacted]

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Although Chinese leaders publicly acknowledge that Chinese prices do not reflect factor scarcities and must be reformed, they have announced that complete price reforms will not come until the economy is stabilized. In the case of price reform, as in other economic reforms, Beijing anticipates some movement in the 1983-85 period. In mid-January, the government revamped textile prices, raising retail prices of cotton textiles in high demand, and lowering retail prices of heavily over-stocked synthetic textiles. Premier Zhao, in his NPC address, stated that prices of fuels will also soon be adjusted. Political considerations, which preclude rapid movement on economic reforms in general, also argue against any dramatic price reform in the near future. [redacted]

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The Party rectification and government reorganization programs are designed in part to replace incompetent or obstructive managerial personnel and improve management methods. Set to begin in mid-year, the rectification--a non-violent purge--is scheduled for completion in the first half of 1986. At the same time, Beijing has announced a plan to reduce sharply government bureaucracy at all levels by 1984, which parallels the move taken at the central government level in May 1982. Although the initial phase of reorganization has been nominally successful, we believe both rectification and reorganization will be tough campaigns and have the potential to sidetrack the economic reform effort. Successful campaigns, however, would remove opponents and provide a political environment conducive to full-fledged economic reforms after 1985. [redacted]

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#### To Reform or Not to Reform?

Since the Third Party Plenum in late 1978, which installed the economic philosophy of the reformers as government policy, reform has traveled a troubled path. The leadership has repeatedly found its reform programs bogged down, either by local officials who are opposed to or afraid of reforms, or by domestic economic conditions that make rapid change impractical. The government's current timetable calls for across-the-board economic reforms after 1985, but we believe it likely that this deadline will be kept in only the best of circumstances. [redacted]

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Nevertheless, the current publicity surrounding the experiments stands in contrast to the situation in 1982, when the uncoordinated push for economic responsibility systems appeared to be all that was left of the post-1978 economic reform program in nonagricultural sectors of the economy. This publicity is the first solid indication in nearly a year that the government is serious about expanding economic reforms. The experiments signal to opponents of reforms that the government is still committed; they also provide clear evidence that reform elements in the government feel strong enough after last year's difficult political meetings--the 12th Party Congress and an NPC session--to make a new run at reform. [redacted]

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We believe the reformers have learned from their experiences of the last few years and will try to implement economic reforms with care, lest they again lose control over important policy variables such as investment spending. And while this experience has undoubtedly dampened some of the ardor for sweeping reforms, we believe reform elements are still convinced that changes are necessary and achievable. We also believe that if they see control over economic policy variables slipping again, they will once more pull back and reassess economic reforms. As a consequence, the program may experience more delays and become less ambitious, but we believe the reform philosophy is firmly enough established that the program will not be completely abandoned.

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